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FEDERAL COMMUNICATIONS COMMISSION OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Telecommunications Services Inside Wiring	)	CS Docket No. 95-184
	)	
Customer Premises Equipment	)	

FURTHER REPLY OF OPTEL, INC.

OpTel, Inc. ("OpTel"), submits this reply to the comments filed in response to the Second Further Notice of Proposed Rulemaking (the "Second Further Notice") in the above-referenced proceeding.

INTRODUCTION

In its comments, OpTel opposed Commission regulation of MDU contracts with MVPDs and supported, instead, a market-based approach to MDU contracting. As OpTel explained in its comments, any Commission-imposed limitation on the use of exclusive contracts would serve only to limit investment in competing facilities. The vast majority of new entrants into the MVPD market agreed with OpTel's approach, some questioning the Commission's authority to mandate MDU access or to prohibit MDU exclusive contracts. Other commenting parties, however, favor Commission regulation of contracts involving the provision of MVPD services to MDUs.

To help resolve this fundamental disagreement regarding the value of exclusive contracting in the MVPD market, OpTel and the Independent Cable and Telecommunications Association ("ICTA") engaged the services of Professor Michael D. Whinston — one of the nation's leading experts on the competitive effects of exclusive contracts — to study current market conditions in the MVPD market and to comment upon the effects of exclusive contracts between MVPDs and MDUs.

Based on Professor Whinston's study, which is being submitted in conjunction with ICTA's reply comments, and upon OpTel's own experience in the marketplace, OpTel continues to support a market-based approach to the handling of MDU exclusive

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contracting. As set forth more fully below, Professor Whinston's study confirms that exclusive contracts expand opportunities for new entrants and add to consumer utility. He further finds that there is "little risk of competitive harm arising from the use of exclusive contracts" by new entrants.[1] He concludes, therefore, that "the FCC should be very careful not to restrict PCO's use of exclusive contracts, and about imposing administrative limitations on their duration, over the judgments of the marketplace."[2]

Professor Whinston agrees, however, that exclusive contracts may have anticompetitive effects when the contracts are negotiated in the absence of competition.[3] It is on this basis that OpTel and others have long advocated the use of the Commission's "fresh look" policy where there has been a market failure, *i.e.*, where perpetual contracts were negotiated before there were competitive checks on the market power of incumbents. Thus, although the Commission generally should permit the market to function where competition is beginning to take hold, it should apply its fresh look policy to perpetual agreements, most of which were executed before there were real competitive alternatives available in the market.

DISCUSSION

I. The Commission Should Not Regulate Private Service Contracts Between Competitive MVPDs And MDUs.

Several parties to this proceeding have questioned the Commission's authority to limit exclusive contracts between MVPDs and MDUs.[4] Whether or not the Commission has such authority, there simply is no rational policy basis for the Commission to exercise it. As Professor Whinston's study demonstrates, absent unequal bargaining power, or a failure of negatively-impacted parties to have their interests represented in the bargaining, exclusive contracting by MVPDs has significant procompetitive aspects without substantial anticompetitive side effects. The Commission should not, therefore, impose artificial regulatory limits on the use of private exclusive contracts by competitive MVPDs.

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1 Michael D. Whinston, Report on the Competitive Effects of Exclusive Contracting for Video Programming Services in Multiple Dwelling Units (Attachment A to the Reply Comments of the Independent Cable & Telecommunications Association) at 2. (the "Whinston Study").

2 Id. at 2-3.

3 Id. at 10-11.

4 See, e.g., Comments of Time Warner Cable at 3, Comments of GTE Service Corporation at 6; see also Comments of Tele-Communications, Inc. ("TCI"), at 5-6 (restrictions on exclusive contracts would "infringe upon significant contractual and property rights.... [including] the most fundamental private property right ... the owner's ability to exclude others.") (quoting Cable Holdings of Georgia v. McNeil Real Estate Fund VI, Ltd., 953 F.2d 600 (11th Cir. 1992)).

A. The Use Of Exclusive Contracts By MVPDs That Do Not Have Market Power Can Help To Facilitate Market Entry And Serve The Public Interest.

Professor Whinston concludes that "exclusive contracting [by private cable operators ("PCOs")] serves an important pro-competitive role in this market, and in particular, may be essential for assuring the competitive participation of PCOs in this market."[5] This accords with OpTel's view that the use of exclusive contracts is necessary for new entrants to attract investment and gain a toehold in the MVPD market.[6]

In a market in which new entrants are seeking to compete with entrenched monopolists, exclusive contracts can greatly expand competitive opportunities and increase consumer utility. As Professor Whinston notes in his study, exclusivity provisions can help parties to an agreement capture what he refers to as "non-contractible investments," *i.e.,* investments that are too uncertain to be addressed explicitly in the contract.[7]

In this context, for instance, a "contracting problem" that Professor Whinston foresees involves incentives that might drive an MDU owner to allow an economically inefficient overbuild, in the absence of an exclusivity provision, once an MVPD has made an initial investment in the MDU.[8] Lacking the ability to deal with this contracting problem with a term of exclusivity, the prospect of such an overbuild "may make the PCO unwilling to invest in the MDU in the first place."[9] Professor Whinston demonstrates how the use of exclusive contracts can deal with this problem by allowing new entrants to protect their investment in facilities to compete with incumbents.[10] Indeed, as OpTel has maintained throughout this proceeding, there is a direct correlation between the duration of exclusivity available to a new entrant and the quality of the facilities and services that it can afford to provide in an MDU.

The comments filed in response to the Second Further Notice support this conclusion. TCI, for example, explains that "since exclusive contracts [allow] MVPDs to extend additional benefits to MDU owners, and since MDU owners will pass these benefits along to their tenants to remain competitive in the real estate market, any

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5 Whinston Study at 2.
6 E.g., Comments of OpTel, CS Docket No. 95-184 (filed Dec. 23, 1997) at 4-5.
7 Whinston Study at 11.
8 Id. at 11-12.
9 Id. at 12.
10 Id. at 12-14.

restrictions which the Commission were to impose on exclusive MDU contracts would simply reduce the potential benefits to MDU tenants."[11] Likewise, a group representing MDU owners and managers notes that, "[w]ithout exclusive contracts, many buildings might not have any kind of video programming service."[12]

The attached letter from Salomon Brothers demonstrates that this simple correlation between exclusivity and investment also is not lost on the financial markets.[13] For a new entrant attempting to attract the capital necessary to compete — and in particular if it seeks to compete on a nationwide basis as OpTel does — a limit on the right to negotiate exclusive contracts would be a devastating blow to its prospects. Thus, to maximize opportunities for OpTel and other competitive MVPDs to attract investment and compete in this market, the Commission should not limit the use of exclusive contracts on a going forward basis.

B. Those Parties That Oppose Exclusive Contracting Start From Flawed Premises.

On the most basic level, a few parties simply misunderstand the affirmative position in favor of the use of exclusive contracts. Winstar, for instance, complains that parties supporting the use of exclusive contracts "are asking for ... an FCC-guaranteed rate of return on their investment in an MDU. In other words, these companies want the Commission to regulate away a portion of their build out risk."[14] Quite the contrary, no party has suggested that the Commission adopt a "mandatory exclusivity" regime in which MDUs would be required to enter into exclusive agreements. Instead, those that oppose FCC regulation in this area simply ask that the Commission allow parties to bargain freely in the market.

Similarly, Media Access Project ("MAP") continues to oppose the use of exclusive contracts and erroneously claims, citing an *ex parte* letter filed on behalf of OpTel on

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[11] Comments of TCI at 24.

[12] Comments of Building Owners and Managers Association Int'l, et al. ("BOMA") at 3.

[13] Letter from Robert J. Gemmell, Salomon Brothers, Inc., to Bertrand Blanchette, OpTel Chief Financial Officer (July 18, 1997) (attached hereto as "Attachment A").

[14] Comments of Winstar at 8; see also Comments of Cox Communications, Inc. ("Cox"), at 4 ("The Commission wouldn't think of adopting regulatory policies which intentionally restrict the number and variety of services that are offered to consumers who live in single family homes. There is no reason why subscribers who happen to live in apartment buildings and condominiums should not enjoy a similar range of service choices."). Oddly, as the Commission's video competition report makes clear, the "range of choices" available to the vast majority of subscribers in single family homes across the United States is one — the franchised cable operator.

February 7, 1997, that exclusive contracts should be capped at five years because it takes only 3.4 years to recover the costs of MDU "inside wiring."[15] In fact, the *ex parte* letter to which MAP refers (attached hereto as "Attachment B") simply demonstrates, as set forth above and supported by Professor Whinston's study, that there is a direct correlation between the investment that an MVPD will make in an MDU and the period of exclusivity that the MVPD is able to obtain. Specifically, the *ex parte* letter to which MAP refers shows that OpTel requires over six years, under the best of circumstances, just to recover the costs of its standard MDU installation. This period does not include any time to earn profits for the provider, and it certainly does not reflect the time required to earn a return that will attract investment from the financial markets. The "inside wiring" costs to which MAP refers also do not include the costs of head-end or microwave facilities, or the costs of the content provided on the system.

Other opponents to a free market approach to MDU contracting argue that "exclusive contracts often motivate MDU owners to make decisions based on factors other than their tenants' interests.... [M]any exclusive contracts include monetary awards to the MDU owner."[16] These concerns, however, simply underestimate the competitiveness of the residential real estate market. Whereas, as the FCC has found, the overall MVPD market generally is not competitive, the residential real estate market is a fully functioning, fiercely competitive, market. Since, "even a small drop in occupancy rates resulting from a failure to provide residents with adequate video programming service would far exceed the revenues a building owner might receive from a service provider in return for an exclusive contract," there is no reason to fear that MDU owners will offer access to sub-standard MVPDs merely to garner some nominal amount of "key-money" or revenue sharing.[17]

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15 See Comments of MAP at 3-4.

16 E.g., id. at 4; Comments of Cox at 5.

17 Comments of the BOMA at 4. As Professor Whinston points out, there is an economic limitation on the amount that an MVPD can pay for access. See Whinston Study at 15. Even if one assumes that key-money and revenue sharing arrangements are paid to MDU owners so that they will allow access to sub-standard service providers, the value of services must decrease incrementally at the same rate that the amount paid to the MDU owner for access increased and, conversely, one would expect that, for each incremental decrease in the quality of service, the MVPD would be required to pay concomitantly more to the MDU owner for access. At the same time, however, the number of subscribers for the service would decrease in direct correlation to the decrease in the quality of service, thereby reducing the value of the access and the ability and incentive of the MVPD to pay for access. Thus, market pressures severely constrain the ability of MVPDs to "buy" MDU access.

The competitive nature of the residential real estate market also disposes of concerns that MDU tenants are not represented in the bargaining between MVPDs and MDU owners. Professor Whinston explains that, "because of the competitive nature of the market for real estate rentals, MDU owners are forced by the marketplace to act as *de facto* representatives, or proxies, for their tenants.... Moreover, with their increasing level of sophistication, MDU owners have every ability to do so as well."[18]

Finally, Cox and Ameritech oppose a free market in MDU MVPD services for reasons that relate to their particular role in the market. Cox, for example argues that "the assertion that exclusive arrangements are critical if MDU service providers are to survive is belied by Cox's own experience with non-exclusive contracts and by the experiences of other cable operators that offer service in direct competition with alternative providers in the same building."[19] As OpTel has noted previously, however, monopoly franchised cable operators such as Cox do not require exclusivity in order to compete because they are able to spread costs over an entire franchise area. Indeed, franchised operators have been known to raise rates for their subscribers in areas in which they face no competition in order to subsidize their ability to compete in areas in which they do face competition. New entrants do not have this luxury.[20]

Ameritech claims — contrary to the Commission's own findings[21] — that service providers competing to provide service to MDUs are not creating a competitive MDU marketplace.[22] Ameritech then proceeds to argue that exclusive contracts will prevent overbuilders, few though there be, from providing service to MDUs.[23] No special relief for Ameritech is warranted, however. Ameritech may, just as any other provider may, compete in the MDU marketplace. A failure on its part to attract customers does not constitute a basis for the Commission to regulate the private agreements of those that do.

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18 Id. at 5-6.

19 Comments of Cox at 5.

20 Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, CS Docket No. 95-61, Comments of OpTel (filed June 30, 1995).

21 1997 Video Competition Report, CS-97-141 (rel. Jan. 13, 1998) ¶ 129.

22 Comments of Ameritech at 3-4. Time Warner's claim, on the other hand, that franchised cable has faced "vigorous competition for almost twenty years" in the MDU submarket, see Comments of Time Warner at 9-10, is overstated. DBS services are a relatively new development in the market and, although SMATV systems have been potential competitors for some time, it was only when the Commission opened the 18 GHz frequency band for use by private cable systems in 1991 that SMATV/private cable obtained the distribution and channel capacity to compete on an equal technical footing with franchised cable.

23 Id. at 4-5.

The Commission should, instead, allow the free market to determine the optimal terms of service for MDU MVPD contracts.[24]

II. Commission Involvement In MDU Contracting Is Warranted Only Where There Has Been A Market Failure.

Professor Whinston's study confirms that although "there is little risk of competitive harm arising from the use of exclusive contracts by PCOs," the same cannot necessarily be said for the contracts signed by cable franchise operators. The difference is that the franchised operators have had, and in some cases continue to have, unequal bargaining power because of a lack of competitive alternatives.[25] It is on precisely this basis that OpTel has urged the Commission to apply its fresh look policies to the perpetual exclusive contracts of franchised cable operators, which generally were entered prior to the advent of MVPD competition in the MDU market.[26]

Although most new entrants into the market and other interested parties support application of the fresh look doctrine in this context,[27] the franchised cable interests oppose fresh look, for reasons that defy logic and common sense. CableVision Communications, Inc. ("CableVision"), for instance, urges the Commission to refrain from issuing "any ruling on presently existing exclusive service contracts, leaving this issue for the open-market to determine."[28] CableVision then proceeds to argue that future exclusive contracts should be capped at five years.[29] Its hard to imagine a more upside-down theory of regulation — CableVision would have the Commission regulate contracts

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24 As several parties point out, Commission regulation in this area is problematic on purely practical grounds. "Any cap which attempts to gauge the length of time for recoupment of investment would be virtually impossible to implement because the recoupment period can vary widely and is affected by a multiplicity of factors, such as the type of technology, services offered, demographics, efficiency of the service provider, etc." Comments of Time Warner at 13; see also Comments of Wireless Cable Association ("WCA") at 9.

25 Whinston Study at 2, 10-11 (franchised operators with market power may use exclusives to reduce competition).

26 Time Warner "disputes the notion that a contract which runs for the term of a cable franchise and any extensions thereof" is perpetual because the franchise terms are fixed and renewals are not automatic, as evidenced by an IRS determination that cable operators may depreciate a franchise. See Comments of Time Warner at 5 (quotations omitted). Without getting into a dispute about the expertise of the IRS in this area, or the actual meaning of the tax rules, there can be little argument over the fact that a franchise non-renewal is an extremely rare event. From the perspective of an MDU owner, waiting for a franchise to be non-renewed in order to escape an agreement that was executed when there were no other choices in the market is, for all practical purposes, the same as waiting in perpetuity.

27 See, e.g., Comments of MAP at 9; Comments of WCA at 11.

28 Comments of CableVision at 2-3.

29 Id. at 4-6.

that are being negotiated in an increasingly competitive environment, while leaving unregulated contracts that were negotiated when CableVision and other franchised operators held virtually absolute monopolies.

Similarly odd is US WEST's suggestion that the Commission "grandfather" existing perpetual exclusive contracts, because they "exist for the convenience of MDU owners who have no interest in periodically negotiating new agreements."[30] US WEST concludes from this that "[t]he Commission should not force these owners to renegotiate their service agreements when they have no interest in doing so" and suggests instead that the Commission impose a mandatory access regime.[31] Naturally, fresh look would not "force" any MDU owner to renegotiate any agreement, but would give them a right to do so for a limited period of time. If an MDU owner decides that it would rather stay locked into a contract with a single provider in perpetuity, it certainly will continue to have the right to do so.[32]

Moreover, US WEST's preference for a mandatory access regime has more to do with its status as a franchised cable operator than any procompetitive policy rationale. Far from increasing consumer choice, mandatory access rules in fact make it more difficult for new entrants to penetrate the market by limiting expected returns in each new system installation.[33] Indeed, it is for this reason that incumbents such as US WEST favor mandatory access.

Finally, Time Warner's opposition to fresh look is based on a misconception. Time Warner apparently believes that application of the fresh look doctrine would "abrogate or cut short the exclusivity term of any exclusive contract" and possibly "restrict the incumbent provider's contractual right to continue to serve the MDU."[34] In fact, as RCN explained in its comments "giving MDU residents and managers the opportunity to take a

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30 Comments of US WEST at 6.

31 Id.

32 US WEST also claims that "no party has alleged that [perpetual] agreements are keeping them out of the MDU video programming marketplace" and that "it is US WEST's experience that there are very few agreements with automatic renewal clauses in existence." Id. at 7. The first assertion reflects an unfamiliarity with the record in this proceeding — OpTel has alleged that perpetual contracts are preventing it from competing for thousands of MDU units in its markets — and US WEST's observation that it does not often encounter perpetual contracts results from the fact that franchised cable operators assiduously avoid competing in each others' markets. A cable operator competing only in its franchised areas is not likely to encounter a perpetual service agreement — other than its own.

33 See Whinston Study at 16.

34 Comments of Time Warner at 10.

'fresh look' at an exclusive contract would not require the MDU to terminate service from the incumbent."[35] The MDU may well elect to continue to receive service under its existing agreement or it may come to a new agreement, either with its current provider or with a new provider.

CONCLUSION

For the foregoing reasons and those set forth in its comments on the Second Further Notice, OpTel supports the application of the fresh look doctrine to perpetual exclusive agreements between MDUs and MVPDs, but opposes any suggestion that the Commission should further regulate exclusive contracts between competitive MVPDs and MDU owners.

Respectfully submitted,
OPTEL, INC.

/s/ W. Kenneth Ferree
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March 2, 1998

[35] Comments of RCN Telecom Services, Inc. at 15.

Attachment A

Salomon Brothers Canada Inc
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Toronto, Ontario M5J 2S1

416-866-2301
FAX: 416-866-7484

Robert J. Gemmell
President and
Chief Executive Officer

Salomon Brothers

July 18, 1997

Mr. Bertrand Blanchette
Chief Financial Officer
OpTel, Inc.
1111 W. Mockingbird Lane
Dallas, Texas 75247

Dear Bertrand:

As you informed us recently, the FCC is considering proposals to limit to no more than seven years the exclusive service agreements between multichannel video programming distributors and the multiple dwelling units ("MDUs") that they serve. We feel that reducing the duration of exclusive contracts to seven years could have a negative impact on the ability of OpTel to obtain external financing.

We had extensive contact with potential and actual investors in private cable companies when we lead-managed the $225 million high-yield offering for you in February 1997. Your current ability to enter into exclusive contracts of sufficient long duration (ten to fifteen years) with MDUs was one of the key selling features for investors. We feel that reducing the exclusivity period to seven years would make it more difficult to attract new investments in OpTel. As you are aware, failure to raise sufficient funds on terms acceptable to OpTel on a timely basis may require you to delay or abandon some of your future expansion or expenditures, which may have a material adverse effect on your growth and your ability to compete in the cable television industry.

Please do not hesitate to contact me if you would like to discuss this further.

Best regards,

Robert J. Gemmell

Attachment B

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OFFICE OF SECRETARY

February 7, 1997

EX PARTE

Chairman Reed E. Hundt
Federal Communications Commission
1919 M Street NW
Washington, D.C. 20554

Re: CS Docket No. 95-184

Dear Mr. Chairman:

As the Commission is moving to conclude the above-referenced proceeding and promote sorely-lacking competition in the MVPD market, franchised cable multiple system operators ("MSOs") have sought to obfuscate the key issues in this proceeding with a goal of eliminating or, at least hamstringing, one of the few sources of competition in that market and certainly the only actual source of competition in the critical multiple dwelling unit ("MDU") segment of the MVPD market.

Central to this campaign of obfuscation, the MSOs have attempted to create an illusory goal of having multiple facilities-based competitors lay wire to each and every MDU resident's door to provide both broadband video services and other broadband telecommunications services. In order to achieve this goal, the MSOs say, the Commission must prohibit MVPD competitors from negotiating exclusive contracts with MDU owners. The MSOs compound the obfuscation by stating that the only reason that MDU owners grant exclusivity is that MVPD competitors pay "kickbacks," which the owners pocket and then proceed to force inferior broadband services upon their residents.

Since the ability to negotiate for exclusivity in the provision of broadband services in MDUs promotes the only feasible wired facilities competition in the MDU market, OpTel, Inc. ("OpTel") and MultiTechnology Systems, Inc. ("MTS") feel compelled to respond and to provide you with information regarding the economic and financial realities we face in bringing competition to the MDU market.

A. The Economics of the MDU Marketplace.

In the United States there are over 13.2 million MDU units in structures of 10 units or more. In terms of MDUs at which private cable operators most often seek to compete, 300 or more units is the norm. Today, approximately 19% of Americans live in MDU units. That number is expected to grow as population density increases and metropolitan areas are revitalized. Consequently, the ability of the Commission to promote an environment in which competition for telecommunications services to MDUs can flourish will, in large part, determine the success of the current efforts to break the monopolies held by service providers at the local level.

In many states, competition to provide video services to MDUs already has begun to develop. Unfortunately, there is an *a priori* competitive imbalance between the monopoly franchised MSOs and the would-be new entrants into the MDU MVPD markets. By virtue of their incumbent status, the MSOs are able to amortize the costs of competing at any given MDU over their entire franchise area. New entrants, on the other hand, must recover their costs building-by-building. As a result, when faced with competition from a new entrant at an MDU, franchised cable operators are able to target pricing discounts to residents of that single MDU to shut-out the new competitor and foreclose market entry. Although this may result in a short term benefit to subscribers, the elimination of competition and the signal it sends to other would-be competitors will have a far more important negative effect on subscriber welfare over the long-term.[1]

It is particularly difficult for competitive providers to respond to such targeted discounts given their need to recover costs on an MDU-by-MDU basis. Moreover, the costs of installing a video distribution system in an MDU are substantial. I have attached a series of exhibits prepared by my clients to illustrate this point.

Attachment A consists of spreadsheets detailing the costs of new construction and retrofits of MDU distribution systems prepared by OpTel. The first spreadsheet compares the expected return on investment, assuming a 17.2% weighted average cost of capital, of a new construction when the alternative provider has exclusive rights versus non-exclusive rights. The second spreadsheet summarizes the costs involved in retrofitting an MDU when the entire cable plant in place must be replaced. As you can see from these two spreadsheets, there is no economic payback on a new-build without exclusivity. Further, even with exclusivity, more than ten years are required for an investor to recover the cost of a new installation. Because of the additional costs involved in retrofitting an existing MDU, this cost recovery period expands to 15 years for an MDU conversion, if complete replacement of the existing cable plant is required.

By comparison, the third spreadsheet summarizes the costs of retrofitting an MDU when some of the existing distribution equipment, including cables and drops, is made available to the new provider. In that case, the cost recovery period shrinks to approximately 6.5 years. Finally, the fourth spreadsheet shows the costs of a new construction using a stand-alone SMATV headend.

As these figures demonstrate, depending upon a variety of factors, including the amount of installed wire that is salvaged, the costs of installing an entire distribution system in an MDU can run from $400-$500 per unit, which translates to

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[1] The ability of franchised cable operators to offer such targeted discounts has expanded as a result of statutory changes to the Communications Act made in the Telecommunications Act of 1996. Under prior law, franchised cable operators were required to price their services uniformly throughout each franchise area. New Section 623(d) of the Communications Act now excepts from the uniform rate requirement non-predatory bulk discounts to MDUs. Although the Commission has not yet determined how it will define what constitutes a "predatory" bulk discount, the removal of the absolute prohibition on non-uniform rates all but invites the franchised cable operators to target discounts to MDUs at which they face competition.

$600-$800 per subscriber, depending upon penetration. Naturally, competing video programming distributors are going to make this investment only if it will result in an economically justifiable return.

Attachment B includes a series of illustrations of how these costs are apportioned in a typical 300 unit, garden-style MDU video distribution system. These illustrations correspond to the spreadsheets in Attachment A. The first illustration shows the costs of a new system installation when the building will be served by microwave as part of a larger network. The second illustration shows the distribution of costs in an MDU retrofit where the entire existing cable plant must be replaced. As you can see from this diagram, the costs of replacing the "inside wire" alone is approximately $60 per unit, which is roughly the difference between a new installation and a conversion.

Again, the third illustration shows the detailed costs of an MDU conversion assuming that the existing cables and drops can be used by the new provider. Not only is $60 per unit for "inside wire" saved, but internal distribution plant costs are reduced by $95 per unit. Finally, the most expensive approach, illustrated in the fourth diagram in Attachment B, involves the construction of a stand-alone SMATV head-end to serve a single MDU. As you can see, the majority of the system costs in that case can be attributed to the head-end as opposed to the distribution and wiring in the MDU.

The bottom line is that the costs of installing a video distribution system in an MDU, whatever the configuration, are substantial. This is particularly true in MDU conversions when the existing cable plant must be replaced. Although the Commission's inside wiring rules apply to MDUs, the current demarcation point (12 inches outside of each individual dwelling unit) between cable company wire and customer inside wire is unworkable in most MDUs. First, the current demarcation point is physically inaccessible in many cases. Second, new entrants cannot afford to overbuild an entire MDU network to use this last 12 inch drop with a dominant provider in place. Third, MDU owners often will not consent to the massive disruptions caused by the construction of a second distribution system that runs to the 12-inch demarcation point. Consequently, the 12-inch demarcation point all but ensures that new competitors will not seek to compete with the monopoly franchised cable operator in most MDUs.

Indeed, the costs of retrofitting an MDU are so substantial that several private cable operators have elected to concentrate their businesses on new buildings and have largely abandoned the existing MDU market to the MSOs. Despite these competitive realities, the MSOs have suggested that the current demarcation point should be retained because it "encourages competing providers to build their own distribution plant" in MDUs and that, therefore, end users will be able to "mix and match" services from two or more providers at their door. The only fair way to describe this claim is sheer fantasy. New entrants simply are not going to make an investment of the magnitude required only to compete subscriber-by-subscriber with an entrenched incumbent operator. The market experience of MTS and OpTel bear this out.[2]

This is not to say, however, that a change in the broadband demarcation point would not be important. Franchised cable operators do use their control over the wires in MDUs to discourage new entry. Often franchised cable operators are able to thwart the efforts of a new service provider to compete by threatening to disable the wires in place so as to make the repair or installation of a competitor's system cost prohibitive even with an exclusive right-of-entry to the MDU.[3] At minimum, such tactics result in service dislocations that are unacceptable to MDU owners and MDU residents. Thus, by moving the demarcation point to a point that would include the entire customer separate wire (*i.e.*, the point at which the wire becomes dedicated to an individual unit), the Commission would take some of the control over the wires in place away from the incumbent service providers and make it more difficult for them to use scare tactics to counter competition.

One of the suggestions that has been made by Time Warner in lieu of moving the demarcation point is the use of a "neutral lockbox" to be shared by competitors competing within an MDU. Even assuming that competition develops along the lines suggested by Time Warner, the "neutral lockbox" approach is unworkable.

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[2] Nothing demonstrates this point more convincingly then the current market, where overbuilding is so rare as to be nonexistent. Time Warner trumpets the fact that Liberty cable in New York now has overbuilt 143 MDUs in Manhattan. Rather than make Time Warner's point, this fact underscores the impracticality of side-by-side networks. Out of the tens of thousands of MDUs in New York — the highest density MDU market in the country — a single competitor, Liberty, has managed to overbuild just 143 MDUs. Moreover, it is our understanding that many of the properties served by Liberty are owned, managed, or controlled by current or former principals of Liberty or its affiliates.

[3] See Letter from Henry Goldberg To Chairman Reed Hundt (filed Feb. 5, 1997).

First, as a technical matter, Time Warner has vastly understated the difficulties of using "neutral lockboxes." For instance, in an MDU with 300 units, each service provider would be required to install 20 to 30 of their own lockboxes, each serving 10 to 12 units, plus there would need to be an additional 20-30 neutral lockboxes. The space required for this set-up would be substantial in all cases and prohibitive in existing MDUs, particularly if additional providers come on-site.

There are also competitive issues raised by the neutral lockbox approach. Apparently, any new provider would be required to rely on the franchised cable operator, its competitor, to ensure that extensions are technically correct and for certain customer service functions, *e.g.*, switching a customer over to the competitor's service. As a practical matter, new entrants will not invest in a system that depends for its success on the goodwill of its competitor.

B. The Need for Exclusivity

Given the economics of the MDU marketplace, the ability of competing service providers and MDU owners to negotiate for exclusive right of entry agreements is essential to the development of competition in this market.[4] Service providers need exclusivity to recover their investment in plant and equipment that is needed to serve a MDU and MDU owners need it to tailor the best package of video and telecommunications services for MDU residents. As discussed above, competitive providers must recover the costs of their system installations MDU-by-MDU. Franchised cable operators, on the other hand, can amortize their costs over their entire franchise areas and support pricing discounts with implicit subsidies from the non-competitive portions of their service areas.

Current exclusive agreements, which are the product of fierce competition between and among the franchised cable operators and one or more private cable or alternative video programming distributors, are vastly different from the perpetual exclusive agreements that were forced upon MDU owners prior to the introduction of significant competition.[5] First, there's a very sophisticated market for MVPD services among MDU owners and condominium owner associations.

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[4] Both OpTel and MTS, for instance, report that they have decided not to compete in several cities that otherwise offer attractive MDU markets, but which are located in mandatory access states.

[5] OpTel has determined that it has been excluded from serving some 41,000 MDU units in OpTel's primary markets alone because of perpetual agreements.

Unlike residents in single family homes who have virtually no bargaining power *vis-a-vis* a cable franchisee, MDU owners bargaining for an entire MDU can negotiate for the highest quality services at the best prices. As a result, today's exclusive agreements typically are for a fixed term of years and include performance standards regarding quality of service, price, channel selection, special services, response times, etc. MDU owners can terminate the contract if the service provider does not stay competitive with other providers in the market on price and service factors. By way of example I have included in Attachment C copies of the performance clauses that appear in the right-of-entry agreements of OpTel and MTS, respectively.

Second, it has been claimed, by Time Warner and others, that in fact all that MDU owners do is choose the MVPD provider that will pay the greatest amount of money to the owner regardless of the quality or type of service involved; in effect, charging a premium for exclusivity and then pocketing that premium. This is simply not the case. Many MDUs around the country are condominia and cooperatives, where the residents either are the owners or the building is managed on behalf of the co-op owners. For the rest, landlords do not lightly ignore the interests of the residents in having high-quality video and telecommunications services in order to line their own pockets. Landlords, in this respect, are acting principally out of self interest, since the residential real estate market is extremely competitive. Landlords are in the business of renting units first and foremost, and no incidental revenue from video services is going to make it economically rational for a landlord to allow a service provider onto the property if the services provided do not meet tenant expectations or are inferior to those of neighboring properties.

Third, the proof as to whether bad service is being forced upon the tenants is whether subscriber penetration rates go up or down when an MDU owner switches from an MSO to a private cable competitor. The subscriber penetration rates experienced by OpTel and MTS demonstrate that tenants are pleased with the new services offered by the competitor. OpTel has found that subscriber penetration rates climb 10% or more after it begins serving an MDU that has previously been served by a franchised cable operator. Similarly, MTS, which specializes in serving newly constructed properties and thus has no means of "before and after" on-site comparison between an MSO and MTS, has penetration rates that compare extremely favorably city-wide with those of franchised cable operators. Whereas penetration rates for franchised cable operators in MTS' markets are in the 50% range, MTS has close to an 80% penetration rate in the MDUs that it serves. Attachment D details market-by-market MTS' penetration rates.

I hope that this information is helpful to you in your consideration of these important issues. I would, of course, be happy to discuss any of the foregoing with you at your convenience.

Respectfully,

Henry Goldberg

cc: William F. Caton
Chairman Reed E. Hundt
Commissioner James H. Quello
Commissioner Rachelle B. Chong
Commissioner Susan Ness
Joseph Farrell
Julius Genachowski
James Coltharp
Suzanne Toller
Anita Wallgren
Marsha MacBride
Meredith Jones
John Nakahata

ATTACHMENT A

Cost Analysis

Cost per Unit Analysis
New Construction

	Exclusivity	Non-exclusivity
Assumptions:		
Number of Units	300	300
Penetration %	60.00%	30.00%
Monthly Revenue per Cable Subscriber	$ 30.00	$ 30.00

	Exclusivity	Non-exclusivity
Capital Expenditures		
Prewire & distribution	$ 298	$ 298
Microwave link	$ 117	$ 117
Master head-end	$ 93	$ 93
Total Costs per Unit	$ 507	$ 507
Total Costs	$ 152,240	$ 152,240

	Exclusivity	Non-exclusivity
Revenue		
Number of Subscribers	180	90
Monthly Revenue	$ 5,400	$ 2,700
Programming Costs	$ (1,884)	$ (942)
Net Revenue	$ 3,516	$ 1,758
Operating Costs	$ (876)	$ (438)
Monthly Operating Cash Flow	$ 2,640	$ 1,320
Payback in Years	4.80	9.61

	Exclusivity	Non-exclusivity
INVESTOR PERSPECTIVE		
Payback in Years with time value of money using weighted average cost of capital of 17.2 %	10.28	no payback

Cost per Unit Analysis
Conversion with complete replacement of existing cable plant

Assumptions:	
Number of Units	300
Penetration %	60.00%
Monthly Revenue per Cable Subscriber	$ 30.00

Capital Expenditures	
Prewire & distribution	$ 360
Microwave link	$ 117
Master head-end	$ 93
Total Costs per Unit	$ 569
Total Costs	$ 170,640

Revenue	
Number of Subscribers	180
Monthly Revenue	$ 5,400
Programming Costs	$ (1,884)
Net Revenue	$ 3,516
Operating Costs	$ (876)
Monthly Operating Cash Flow	$ 2,640
Payback in Years	5.39

INVESTOR PERSPECTIVE	
Payback in Years with time value of money using weighted average cost of capital of 17.2 %	15.37

Cost per Unit Analysis
Conversion Existing Distribution

Assumptions:	
Number of Units	300
Penetration %	60.00%
Monthly Revenue per Cable Subscriber	$ 30.00

Capital Expenditures	
Prewire & distribution	$ 205
Microwave link	$ 117
Master head-end	$ 93
Total Costs per Unit	$ 414
Total Costs	$ 124,340

Revenue	
Number of Subscribers	180
Monthly Revenue	$ 5,400
Programming Costs	$ (1,884)
Net Revenue	$ 3,516
Operating Costs	$ (876)
Monthly Operating Cash Flow	$ 2,640
Payback in Years	3.92

INVESTOR PERSPECTIVE	
Payback in Years with time value of money using weighted average cost of capital of 17.2 %	6.58

Cost per Unit Analysis
New Construction with SMATV

Assumptions:	
Number of Units	300
Penetration %	60.00%
Monthly Revenue per Cable Subscriber	$ 30.00

Capital Expenditures	
Prewire & distribution	$ 298
Microwave link	$ -
SMATV head-end	$ 400
Total Costs per Unit	$ 698
Total Costs	$ 209,400

Revenue	
Number of Subscribers	180
Monthly Revenue	$ 5,400
Programming Costs	$ (1,884)
Net Revenue	$ 3,516
Operating Costs	$ (876)
Monthly Operating Cash Flow	$ 2,640
Payback in Years	6.61

INVESTOR PERSPECTIVE	
Payback in Years with time value of money using weighted average cost of capital of 17.2 %	No payback

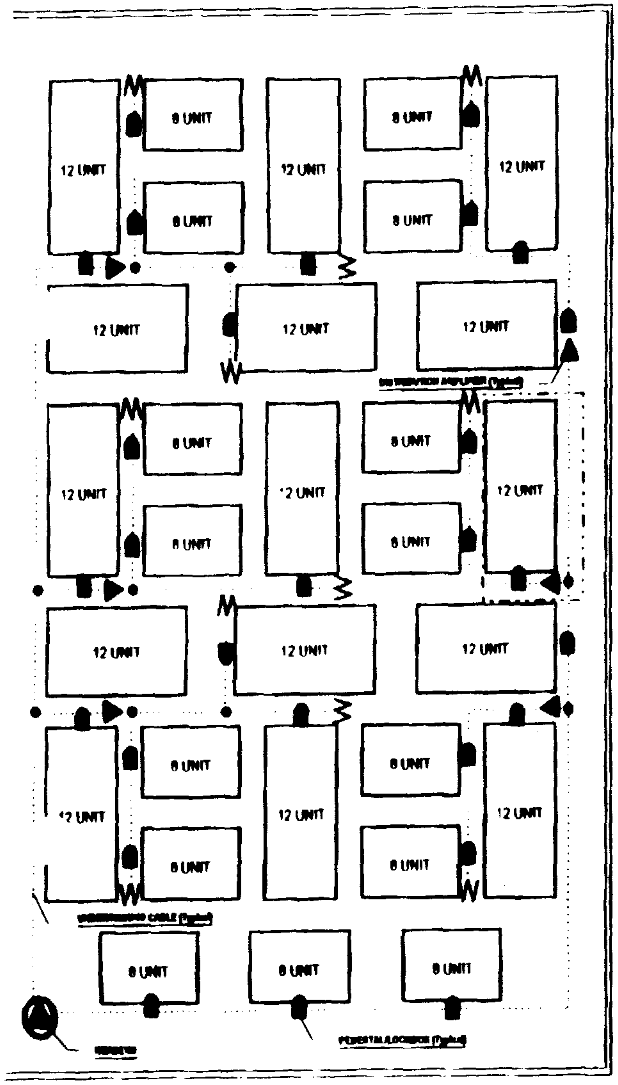
ATTACHMENT B

System Diagrams

TYPICAL 300 UNIT GARDEN STYLE APARTMENT (6 ACRE CAMPUS)

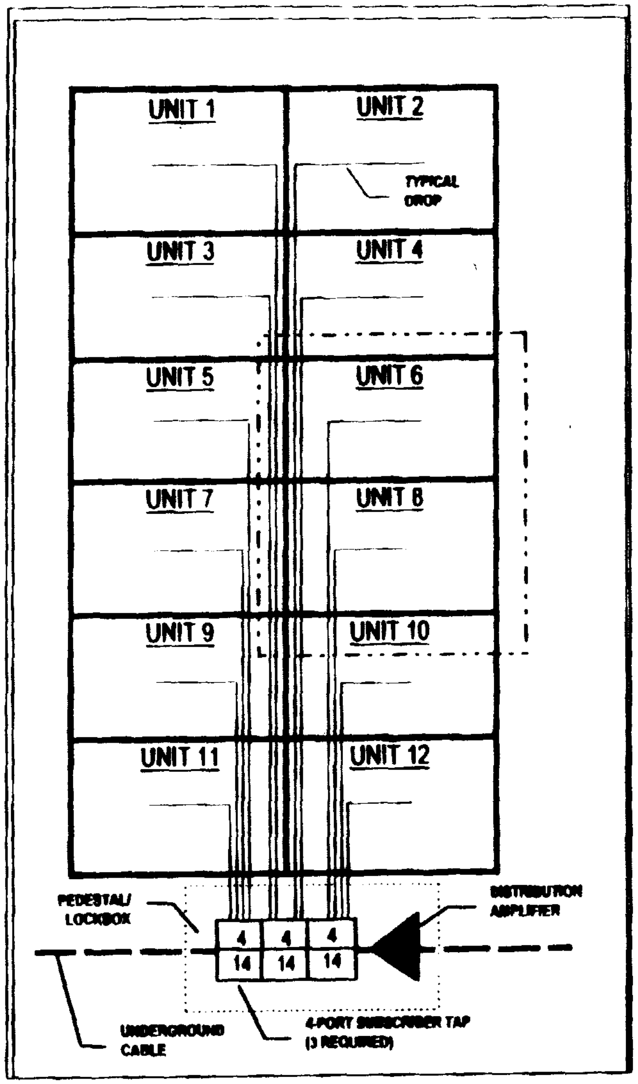
New Construction - Network

TYPICAL PROPERTY SITE



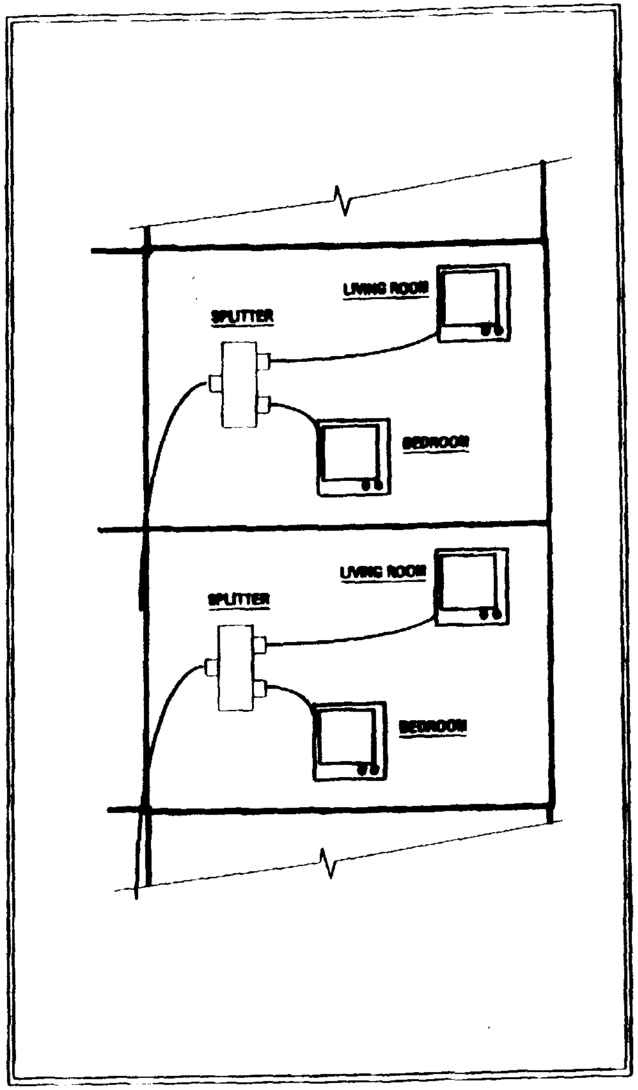
HEADEND ALLOCATION = $93
MICROWAVE = 117
TOTAL H/E COSTS = $210/UNIT

DISTRIBUTION SYSTEM DETAIL



DISTRIBUTION COSTS = $250/UNIT

TYPICAL PREWIRE



PREWIRE COSTS = $40/UNIT

TOTAL AVERAGE COST = $500/UNIT